

ORIGINAL

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

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In the Matter of )  
 )  
Allocation of Costs Associated With )  
Local Exchange Carrier Provision )  
of Video Programming Services )

CC Docket No. 96-112

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COMMENTS OF U S WEST, INC.

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## SUMMARY

Although joint use of common facilities is expected to increase, the Federal Communications Commission (“Commission”) need not specify cost pools and dictate uniform procedures in order to protect against cross-subsidization. It need only provide general guidelines as to what methodologies reasonably could be employed to allocate common costs between regulated and nonregulated services. Through the current cost allocation manual (“CAM”) approval process and other controls (e.g., audits), the Commission can ensure that regulated ratepayers do not cross-subsidize nonregulated services.

While there is no absolute formula that will produce equitable results in every case, the Commission’s proposed 50/50 fixed factor approach could work as long as the 50/50 split of common costs is made on a per subscriber basis. Other approaches might also work, depending on the incumbent local exchange carrier’s network architecture, the rate of deployment and other factors. Again, as with Open Video Systems generally, flexibility is key.

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**COMMENTS OF U S WEST, INC.**

U S WEST, Inc. ("U S WEST") hereby files its comments on the Notice of Proposed Rulemaking in the above-captioned proceeding.<sup>1</sup> In view of its significant in-region telephony and out-of-region cable interests, U S WEST has considered the issues raised in the Notice from both the telephone company and the cable company perspective. As a result, U S WEST has developed a workable approach that is fair and equitable to both sides of the business and that, by analogy, is fair and equitable to the two converging industries squaring off in this proceeding: telephone and cable.

I. **INTRODUCTION**

As the Federal Communications Commission ("Commission" or "FCC") recognizes in the Notice, the overarching goal of the Telecommunications Act of

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<sup>1</sup> See In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, CC Docket No. 96-112, Notice of Proposed Rulemaking, FCC 96-214, rel. May 10, 1996 ("Notice"); see also Order, DA 96-839, rel. May 24, 1996.

1996<sup>2</sup> is to “provide for a procompetitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition . . . .”<sup>3</sup> The Commission’s action in this proceeding will impact significantly the incentives of incumbent local exchange carriers (“LEC”) to deploy technologies that will bring competition to the video services marketplace, as well as their incentives to upgrade their networks in order to compete with new entrants in the local exchange market. Accordingly, the rules adopted in this proceeding must be fair and equitable, and they must be sufficiently flexible to permit LECs employing different technologies and different architectures to make reasonable cost allocations that will prevent cross-subsidization.

If the Commission attempts to impose a rigid cost allocation regime that fails to account for the legitimate differences among the LECs, the Commission likely will send uneconomic signals to market participants that ultimately could retard the development of true, facilities-based competition in both the local exchange and video programming service markets. As U S WEST demonstrates below, any formula or approach that arbitrarily over allocates common costs to nonregulated services is anticompetitive and inconsistent with the 1996 Act because it would

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<sup>2</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (“1996 Act”).

<sup>3</sup> Telecommunications Act of 1996 Conference Report 104-458 at 113 (Feb. 1, 1996) (“Conference Report”). See also Notice ¶ 1 and n.2.

retard investment on the nonregulated side of the incumbent LEC's business, and would lead to artificially low prices on the telephony side. Neither of these outcomes would promote the competition that the 1996 Act is designed to foster.

## II. FOCUSING SOLELY ON CROSS-SUBSIDIZATION AT THE EXPENSE OF DEVELOPING COMPETITIVE MARKETS WOULD BE INCONSISTENT WITH THE 1996 ACT

In allowing common carriers to enter the video programming marketplace, Congress intended "to promote competition, to encourage investment in new technologies and to maximize consumer choice of services that best meet their information and entertainment needs."<sup>4</sup> Rather than encouraging LEC entry into the video services marketplace through the Open Video Systems ("OVS") model, the Commission seems to be primarily concerned with protecting the regulated ratepayer from cross-subsidizing nonregulated services.<sup>5</sup> Preventing cross-subsidization is an important goal, but competition is at least as important. A sensible, flexible approach is needed to achieve both.

If the Commission errs too far on the side of protecting the regulated ratepayer, there likely will be nothing to cross-subsidize. In other words, excessive measures that go too far in preventing cross-subsidization would stifle LEC participation in the delivery of video programming services to consumers, and

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<sup>4</sup> Conference Report at 172.

<sup>5</sup> See Notice ¶ 22 ("To ensure that telephone subscribers are not forced to pay for the nonregulated offerings of the incumbent local exchange carriers, including video programming services, we address specific issues concerning the allocation of joint and common costs.").

would in turn deprive consumers of choices that the 1996 Act is designed to create. To put it bluntly, the Commission appears to be dangerously close to making the same mistake with OVS as it did with video dialtone: regulatory overkill.

The Commission can best serve the regulated ratepayers' interest by providing incentives for incumbent LECs to make network investments and upgrades that will ultimately result in lower prices in all markets because the network will be utilized more efficiently, and costs will be spread over a larger base. As the FCC's Chief Economist Joseph Farrell recently recognized, "cost allocation is a dark mystery,"<sup>6</sup> and the long-run answer is to *stop trying to allocate costs*.<sup>7</sup> Rather, policy-makers should "encourage competition in loops and switches and then competing carriers will offer whatever prices of packages they want."<sup>8</sup> U S WEST wholeheartedly agrees with these unofficial views, and urges the Commission to rethink some of the tentative conclusions and proposals set forth in the Notice because they will not encourage the competition in video services that the Commission so ardently desires, and that the American public deserves.

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<sup>6</sup> "Creating Local Competition," Speech by Joseph Farrell, Chief Economist, FCC, Washington, DC (May 15, 1996), at 5.

<sup>7</sup> Communications Daily, Vol. 16, No. 100, at 2 (May 22, 1996) (emphasis added).

<sup>8</sup> Id., quoting Joseph Farrell at May 21, 1996 Brookings Institution briefing.

### III. NO MAJOR CHANGES TO THE CURRENT PART 64 RULES ARE NEEDED

The Commission posits that its current cost allocation rules were not designed to account for an incumbent LEC's use of the same network facilities to provide video programming service and other competitive offerings not subject to Title II regulation, as well as telephony and other Title II offerings.<sup>9</sup> The Commission then considers adopting certain severe approaches, some of which have never been used before, e.g., prescribed cost pools, uniform allocations and fixed factors.<sup>10</sup> While general guidelines with respect to allocating common costs between video and telephony would be helpful, the Commission need not go as far as the Notice suggests in revising its cost allocation rules.

The Commission designed its cost allocation rules to be flexible to adapt to many different types of services. In the Joint Cost Order, the Commission explicitly adopted cost allocation standards for use in apportioning costs between regulated and non-regulated activities, and defined non-regulated activities as "activities which have never been subject to regulation as communications common carrier offerings" and "preemptively deregulated activities."<sup>11</sup> OVS is not subject to Title II, and it clearly fits within the definition of a non-regulated activity. While use of

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<sup>9</sup> Notice ¶ 2.

<sup>10</sup> Id. ¶¶ 27 and 38.

<sup>11</sup> In the Matter of Separation of costs of regulated telephone service from costs of nonregulated activities., Report and Order, 2 FCC Rcd. 1298, 1299 ¶¶ 2 and 3, 1342 (1987) ("Joint Cost Order"), aff'd sub nom. Southwestern Bell Corporation v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

shared network investment probably will increase, the Commission's rules are flexible enough to address future services with minimal guidance. As the Commission has acknowledged, "the [current] rules . . . should be suitable for an increasingly competitive telecommunications environment."<sup>12</sup>

U S WEST strongly opposes the Commission's tentative conclusion that it should prescribe specific cost pools and allocation factors for allocating video programming and other nonregulated service costs.<sup>13</sup> The Commission is regulating in a vacuum, and should not set specific rules that likely will not work when applied to nonregulated services which will be offered in ways that cannot be foreseen today. LECs will use different technologies and different network architectures to deploy such services, which means that a "one-size-fits-all" approach to cost allocation is not feasible. General guidelines are much more desirable because they will accommodate variances between the LECs and still result in a fair and equitable allocation of common costs to nonregulated services.

U S WEST also disagrees with the Commission's tentative conclusion that "[u]niform allocation methods will . . . foster competition in local exchange markets by allowing direct comparisons of cost allocations among incumbent local exchange carriers and helping highlight anomalies that may signal competitively harmful cost misallocations."<sup>14</sup> Uniformity will do nothing to foster competition, but rather

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<sup>12</sup> Joint Cost Order, 2 FCC Rcd. at 1304 ¶ 40.

<sup>13</sup> Notice ¶ 27.

<sup>14</sup> Id.

will stifle it by failing to recognize and account for the legitimate differences among the LECs in terms of their accounting systems and network architectures. Besides, the Commission has many years of experience with Part 64, and has permitted slight variances among the LECs.<sup>15</sup> In view of the deregulatory spirit and intent of the 1996 Act, it makes no sense to start requiring all LECs to conform their cost allocation accounting practices to a single set of rules.

Moreover, rigid rules uniformly applied to all LECs could stifle new product and service introduction. While the task of reviewing cost allocation manual (“CAM”) changes and auditing LEC accounts may seem cumbersome, it is nothing compared to the challenges that LECs face in entering video markets where experienced incumbents are already girding themselves for competition. Administrative simplicity is a worthy goal, and one that U S WEST supports, but achievement of that goal should not come at the expense of the undeniably higher goal of developing competition in the delivery of video programming services to consumers.

Current reporting and auditing requirements are more than adequate to ensure that LECs do not cross-subsidize. Incumbent LECs file CAMs with the Commission that list all cost pools used to directly assign and allocate regulated

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<sup>15</sup> See, e.g., In the Matter of BellSouth Telecommunications, Inc., Petition for Waiver of Section 64.901(b)(4) of the Commission’s Rules that Govern the Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Memorandum Opinion and Order, 10 FCC Rcd. 583 (1995); In the Matter of Pacific Bell Reallocation of Nonregulated Investment, Memorandum Opinion and Order, 9 FCC Rcd. 492 (1994).

and nonregulated costs. The actual results of these allocations are reported in the ARMIS 43-03,<sup>16</sup> and are audited annually. The Commission should continue to review LEC cost allocation decisions through the normal CAM process, and each LEC should be entitled to justify its approach under the existing rules.

IV. **A 50/50 SUBSCRIBER BASED METHODOLOGY WOULD PRODUCE MORE EQUITABLE RESULTS THAN AN ALLOCATION OF ALL COMMON COSTS BASED ON A FIXED FACTOR**

The Commission has proposed a fixed factor for allocating loop plant common costs between regulated and nonregulated activities.<sup>17</sup> Specifically, the Commission has proposed a 50 percent allocation factor that would split the common costs of loop plant equally between regulated and nonregulated activities.<sup>18</sup> The Commission favors the fixed factor approach because it “would be simpler to apply and to audit than a usage-based approach.” and because it can be applied uniformly among carriers.<sup>19</sup> U S WEST agrees that the 50/50 fixed factor approach as set forth in the Notice would be easy to administer because, if adopted without clarification and refinement, there probably would be little incumbent LEC video activity for the Commission to monitor.

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<sup>16</sup> See In the Matter of Revision of ARMIS USOA Report (FCC Report 43-02), ARMIS Joint Cost Report (FCC Report 43-03) and ARMIS Access Report (FCC Report 43-04) for Tier 1 Telephone Companies, AAD 96-34, Order, DA 96-297, rel. Mar. 6, 1996 ¶ 2.

<sup>17</sup> Notice ¶ 40.

<sup>18</sup> Id. ¶ 39.

<sup>19</sup> Id. ¶ 42.

Under the 50/50 fixed factor approach, normal network upgrades and replacement of facilities might be chilled because the LEC would often face an uneconomic allocation of the cost associated with that upgrade. For example, U S WEST may install Variable Digital Subscriber Loop (“VDSL,” or “copper re-use”) technology in certain areas purely for telephony reasons. VDSL is capable of carrying video signals. If U S WEST later elected to offer video programming services over a portion of that network, 50 percent of the common costs immediately would be allocated to nonregulated.

The inequitable and arbitrary effects of an absolute 50/50 fixed factor approach can be demonstrated in a simple example. Assume that a LEC has 1,000 loops each with a cost of \$500. The total common cost of 1,000 loops is thus \$500,000. Assume that one telephony customer elects to receive video services over one of those loops. Under a straight 50/50 fixed factor approach, the LEC would have to allocate immediately 50% of the common loop costs (or \$250,000) to nonregulated services. The LEC would then have only \$250,000 of common costs that it could recover on the regulated side (requiring a reduction in telephone rates under rate of return), and would have only one video customer to cover \$250,000 in common costs on the nonregulated side.

As demonstrated by this example, the straight 50/50 fixed factor approach produces a “double-whammy” for the LEC. First, it would cause a drastic overallocation of costs to the nonregulated side during the crucial start-up phase of a new business in a mature market, requiring the LEC to absorb heavy losses for an

extended period of time. As if that were not bad enough, it would also cause an artificial lowering of costs on the regulated side, resulting in a reduction in residential telephone rates at a time when residential telephone rates are *already* below cost. Under these conditions, no sensible LEC would introduce video services using common facilities if required to allocate common costs in this manner. Moreover, facilities-based potential entrants into the local exchange business (e.g., cable companies) would have little incentive to compete for residential telephone customers if residential rates were pushed so low that entry became a losing proposition.

In order to encourage the innovation and investment necessary for the introduction of new services, the Commission should allow LECs to employ an allocation methodology that more accurately reflects the benefits derived from the joint use of loop plant. U S WEST favors a 50/50 subscriber-based approach, meaning that a 50/50 allocator would still be applied, but only to the loops actually used for both video and telephony.<sup>20</sup> The overall approach can be summarized as follows:

- All new construction that can be specifically identified with non-regulated activities would be directly assigned 100% to non-regulated accounts.

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<sup>20</sup> While U S WEST believes that this approach would result in fair and equitable allocations, U S WEST does not mean to suggest that it is the only approach. Each LEC should have flexibility within general guidelines to determine a reasonable allocation of common costs, subject to Commission audit and review.

- Common plant construction that can be supported solely by telephone needs would be directly assigned 100% to regulated accounts.
- If common plant construction costs are higher than necessary to meet telephone needs, the additional costs would be directly assigned 100% to video.
- The costs of any common plant used to provide video services would be allocated 50% to non-regulated accounts on a per subscriber basis.

The basic idea is that direct assignment of costs can and should still be made whenever possible. Costs incurred for telephony reasons would be directly assigned to regulated accounts. Any additional costs beyond telephony Present Method of Operation (“PMO”) would be directly assigned to nonregulated accounts.

Here is how the subscriber-based 50/50 methodology would work in conjunction with direct assignment: assume that the PMO cost to construct a new loop for telephony purposes is \$80. If the LEC chose to spend \$100 on that construction, \$20 would be directly assigned to video. Then, the \$80 common cost would be split equally (50/50) based on the number of video subscribers. So, if there were 100 video subscribers, 50% of the common loop cost for 100 loops would be allocated to video (i.e.,  $(50\% \times \$80) \times 100 = \$4,000$ ). This is the methodology that U S WEST Communications, Inc. filed in its video dialtone tariff.<sup>21</sup>

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<sup>21</sup> See In the Matter of US West Communications, Inc. Tariff FCC No. 5, Market Trial of Basic Video Dialtone Service in Omaha, Nebraska, Order, 10 FCC Rcd. 12184 (1995); In the Matter of US West Communications, Inc. Request for Temporary Waiver of Sections 69.110, 69.112 and 69.305(b) of the Commission’s Rules to Permit the Establishment of Tariff Rate Elements for Basic Video Dialtone Service for a Limited Market Trial in Omaha, Nebraska, Order, 10 FCC Rcd. 10862

The 50/50 subscriber based methodology offers several benefits. First, by making the allocation on a per customer basis, it more accurately reflects actual usage of the network than an arbitrary 50/50 allocation of all common costs. This is preferable than presuming from Day 1 that the nonregulated services utilize the local loop equally as much as regulated services do. Second, the 50/50 subscriber based methodology accounts for growth of the nonregulated service, and permits a more gradual reallocation of costs from the regulated side of the business. It also encourages more productive use of the existing telephone plant which benefits the regulated ratepayer and is a primary focus of the Commission's price cap rules.

V. **FORECASTING SHOULD NO LONGER BE REQUIRED IF  
THE LEC EMPLOYS AN ALLOCATION METHODOLOGY  
BASED ON ACTUAL NUMBER OF VIDEO SUBSCRIBERS**

U S WEST supports elimination of the three-year peak forecast requirement in the current Part 64 rules.<sup>22</sup> This requirement is burdensome and would be unnecessary going forward because under the 50/50 subscriber based method discussed above, the allocation of common loop costs to video would be based on the actual number of video subscribers. This number can be readily obtained and audited.

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(1995). U S WEST Communications, Inc. filed Transmittal No. 657 to introduce its Basic Video Dialtone Service on August 11, 1995; certain provisions of Transmittal No. 657 were revised with the filing of Transmittal No. 665 on August 29, 1995.

<sup>22</sup> 47 CFR § 64.901(b)(4).

In addition, the three-year peak forecast requirement results in the establishment of a floor under which the nonregulated investment can never dip. It would not be equitable to require a LEC's video business permanently to fund embedded telephone plant if that plant were used by the video business for a limited period of time. In other words, the Commission should not artificially foreclose LEC exit options. LECs should be able to freely enter and exit video markets based on market conditions, and should not be faced with unrecoverable sunk costs and stranded investment created by cost allocation rules. This is especially relevant in the video market where industry churn rates are widely recognized to be as high as 33-36%.

By analogy to the proposed interconnection rules, maintaining the floor for nonregulated investment would be tantamount to requiring an interexchange carrier to pay the remaining cost of the plant used for a resold service. The Commission's policy should be that non-regulated LEC affiliates must pay a share of common embedded plant, but only while it is being used for nonregulated services. This would be fair to telephone ratepayers, LEC shareholders, and competitors in the provision of video programming services.

VI. RATEPAYERS SHOULD BEAR THE COST OF NETWORK IMPROVEMENTS WHEN MADE FOR TELEPHONY PURPOSES

At paragraph 54 of the Notice, the Commission asks to what extent ratepayers should be required to pay for network improvements that incumbent

LECs make in anticipation of future competition in their core markets. The Commission should not fail to recognize that the need to continue to provide high-quality, up-to-date service at an affordable price requires LECs to upgrade and replace facilities. The fact that the upgraded facilities may be capable of providing additional nonregulated services in the future should be viewed as an advantage to the regulated ratepayer because the nonregulated service customers would pay for a share of the common costs that were previously borne solely by the regulated ratepayers. For example, the replacement of electromechanical switches with electronic stored program control switches not only reduced maintenance costs on the telephony side of the business, but also afforded the opportunity for custom calling features (e.g., call forwarding, speed calling), the revenues from which have enabled telephone rates to be kept lower than they otherwise would have been. The Commission should not attempt to establish through rules adopted in this proceeding what future network improvements and upgrades are properly borne by regulated ratepayers. This question can be effectively addressed on a case-by-case basis through the current CAM approval process.

## VII. CONCLUSION

While U S WEST appreciates the Commission's desire for administrative simplicity, the allocation of common costs between regulated and nonregulated services is not conducive to a fixed, uniform solution. The complexity of cost issues and the variations among incumbent LECs require a more flexible approach that

builds on the existing rules. With some refinement and clarification (i.e., making clear that the 50/50 allocation is made on a *per subscriber* basis), the Commission's proposed fixed factor approach could work in some cases, perhaps not so well in others. It is important that the Commission recognize the legitimate differences among the LECs, and not stifle their incentives to invest in OVS and other video delivery technologies by adopting rules that would require new, nonregulated businesses to carry a disproportionate share of common costs.

Respectfully submitted,

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I, Kelseau Powe, Jr., do hereby certify that on this 31st day of May, 1996, I have caused a copy of the foregoing **COMMENTS OF U S WEST, INC.** to be served via hand-delivery upon the persons listed on the attached service list.



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